Securities Industry

TRENDS

An Analysis of Emerging Trends in the Securities Industry
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THE NORTH AMERICAN SHAKEOUT: STRATEGIES FOR TOUGH TIMES[1]

The securities industry vs. market and economic cycles
Overcapacity and price competition
Cost control and profitability
Individual investor's role in the market

RECENT SECURITIES INDUSTRY & MARKET TRENDS

Profitability and business conditions
American finance and the excesses of the 1980s
Leveraging and the diminishing role of equities
U.S. taxation vs. savings and capital formation

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1 This issue of *Trends* excerpts observations and commentary about the current and future state of the securities industry from presentations by SIA President, Edward I. O'Brien, and SIA Senior Vice President and Director of Research, Jeffrey M. Schaefer. Mr. O'Brien's presentation was before a May 30 conference, entitled "Financial Institutions: The Shakeout," sponsored by the *Financial Post*, Toronto, Canada; and Mr. Schaefer's presentation was before the May 23 Eastern Region Meeting of the National Association of Securities Dealers. Contributions and editing by George R. Monahan, SIA Director of Industry Studies. SIA welcomes contributions to *Trends* from all sources, from member firms as well as others, relating to the securities industry and capital markets. Please send submissions to the attention of Jeff Schaefer or George Monahan, SIA Research Department.

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THE NORTH AMERICAN SHAKEOUT: STRATEGIES FOR TOUGH TIMES

The securities markets, and particularly the securities industry, are looking healthier today than we have seen in a long, long time. Although the equity and bond markets are doing fabulous right now and the profitability picture in our industry has changed dramatically, for the better, over the past few months, the securities industry's three-year recession and last year's record loss are still quite fresh in mind.

First, a little background of that "shakeout period" we've just come through. The U.S. securities industry had a $162 million pre-tax loss last year, the first loss since 1973's $72 million in red ink. In fact, NYSE member firms reported aggregate losses in four of the past five quarters ended last year.

The industry's equity base last year fell to its lowest level since 1986. Total capital fell to $35.8 billion, the lowest level since the 1987 crash. Commissions, a mainstay of the business for many firms, fell each quarter last year to a nadir not seen in many years. Finishing at $2 billion in the fourth quarter, quarterly commission levels were the same as late 1982 to early 1984. For full year 1990, total commissions of $8.9 billion were down 13% from 1989, and a sharp 30% below 1987's peak.

Securities industry employment contracted 20% since the crash, from 262,000 to 210,000; this is the lowest industry workforce since 1984. I could go on and on with sobering statistics on the industry's recession, but more important is "what have we learned from this experience?"

First and foremost, the securities industry has always been, and will always be to some degree, a captive of market events, and ultimately, macro-economic events, which cycle their way through our economies and over which the industry has no control. If you're a discount broker, or a retail firm, relying on commissions from individuals for 50% or more of your revenues and profits, you are likely to suffer when volume is down, when retail investors are not willing to make new investments. When real interest rates soar, investors will be prone to shift out of equities into fixed income securities. When the economy is in recession and unemployment is high, it curtails consumer spending and investment. When corporate earnings are down, the markets are down and volume is low, it's hard to show stellar results.

There are ways to hedge that; to diversify so that your revenues are not contingent on any one sector. But, the economy and the markets are intertwined and they will have good periods and they will have down periods, and if you are in the securities business there is no way to totally escape this cyclicality. This is as basic a conclusion as you will ever reach about this industry.

One thing our industry learned during this most recent tough period is that you have to watch your costs. At many firms, expenses did really get out of control in the 1980s. It is necessary to watch the bottom line in all businesses. As the headlines of the early-to-mid 1980s splashed stories of mountains of cash being made on Wall Street, and revenues were pouring in in record amounts back then, not only the public but in too many cases securities firm management itself became enraptured with the myth of endless profitability. MBAs were scooped up from every graduating class from every

B-school at ever escalating salaries. Clerical and administrative support staff were hired in numbers two-to-one for every producer added. Systems personnel, new and expensive technology, new headquarters buildings, new branch offices were all added on feverishly to grab a piece of the growing pie.

Industry Overbuilt in the 1980s

The sheer size and magnitude of the growth of the 1980s blinded many to a growing profitability problem in its midst, as well as to the often transitory nature of our revenues. Employment almost doubled in the 1980s, but compensation costs tripled. Revenues increased over three-fold, but expenses increased over four-fold. Meanwhile, profits, even at their peak, only doubled from the decade's start, and then crashed into the negative zone. Profitability measures, such as ROE, profit margins, etc., all peaked in 1980 and then declined during the "growth" period of the 1980s.

The industry overbuilt and there was overcapacity. Price competition was fierce and margins thinned or turned negative. Not dissimilar to London's *Big Bang*, many, if not most, firms continued to expand in the midst of these warning signs, layering on more costs in an effort to follow the bull.

Crash Brought Painful, But Necessary, Controls

Then came the 1987 crash. The growth ended and the over-extended cost base and shrinking profitability could no longer be masked by more and more revenues. What did the industry do? We cut and slashed. And the cuts were as feverish as the growth had been and as dramatic as the crash had been.

Most of these cuts were painful. Since the crash, one out of five securities industry jobs has been lost — over 50,000 of our former colleagues and friends are no longer in the industry. Entire lines of business which were revenue generators but profit losers have been eliminated. Salomon Brothers, until its exit the number one U.S. underwriter of municipal bonds, dropped out of this business just prior to the crash. Many securities firms and banks have since done likewise and most municipal departments are now dramatically smaller, streamlined or merged into other capital markets departments.

Prudential Securities has abandoned its efforts to be a major capital markets player. Many firms have dropped their self-clearing businesses, becoming correspondent firms, basically outsourcing this infrastructure cost base. Outsourcing has been used for other areas: research, systems, technology, mutual funds, etc. Many firms have merged to consolidate back office costs, to find some higher economies of scale. Some firms, faced with overcapacity and cost problems, simply closed their doors.

The point to be made here is that, as losses mounted, the attack on costs was necessarily dual in approach. The easier cost cutting was in the obvious areas: personnel, both clerical and professional; travel and entertainment; advertising; outside consulting fees; technology expense; closing of some offices; freezing of compensation; reduction of bonuses, and cutbacks in hiring.

The more difficult area involves cost-cutting as it relates to long range business plans. Here a firm, in cutting expenses, finds itself impacting several parts of the business when it cuts expenses in another area. Or a firm is faced with the reality that its deeply held business plans must be curtailed or in some cases abandoned.

These cuts, and other areas of cost controls enacted since the crash, will, when completed, position our industry to meet the challenges of the 1990s from a more realistic cost base. Hopefully, the lessons learned during these three years will be constantly refreshed in management's mind, built upon and embellished, not simply forgotten as the revenue line on the chart spikes up again as it is now doing.

Planning for the Future

Overcapacity and price competition are still with us today, even as the markets rebound. The current state of price competition in the industry calls for further cuts in costs relating to institutional equities, in underwriting and even in the newest business line darling, asset management. We have to plan for lower prices in these areas, whether they continue to generate more revenue or not.

We have to look at how we deploy our assets and our people. Studies have shown that in the past five years, the mix of business contributing to the industry's bottom line, and a shrinking bottom line at that, changed dramatically. Retail's contribution to profits altered dramatically. Total retail's contribution fell from about 20% of profits in 1986, prior to the crash, to about 10% the last three years. Traditional retail brokerage alone, where the vast majority of the industry's employment, physical plant and other efforts are concentrated, went from a mere 13% contribution to the bottom line in 1986, a good year, to a *consumer* of 10% of industry profits since the crash. If not for asset management, which climbed from less than 10% of total profits in 1986 to over 20% last year, total retail would have continued to show bottom line losses for the industry. Meanwhile, more than half of all profits industry-wide have been from M&A and proprietary trading.

This disequilibrium in the profit mix is dwarfed by the disequilibrium in the distribution of the workforce earning these profits. Less than 2% of our workforce is bringing in over half the profits which means there has to be some basic rethinking of our payroll cost base, our largest expense other than interest, and the infrastructure to support this workforce.

Studies have also shown that the securities industry employs six times as many professionals to handle institutional accounts than the institutions themselves employ to manage their huge portfolios. If there is one reason why institutional sales is a break-even, or in some cases, a loss business, this could be it.

We've heard a lot about globalization over the past decade and how important it is to get on this bandwagon for our future profitability. But we also saw what *Big Bang* did to profitability. There's overcapacity in international business and there is only so much room for so many major participants. Others have succeeded in capturing international business, or in capturing domestic business overseas, through alliances and joint ventures, a means of keeping investment low but broadening your horizons. These have been accomplished both by securities firms and various

exchanges. Yet, the movement is still towards more internationalization and the expansion of free trade across more borders in the future. Again, plan for it.

I've mentioned that compensation is the industry's largest non-interest expense. Gross interest expense has gone from 20% of revenues in 1980 to 42% last year. Of course, this is weighted by the large investment banks and the industry is still earning net interest income. Nevertheless, with gross interest revenues and expenses both approaching half of our total revenue base, the industry's vulnerability to shifting machinations of macro-economic events affecting interest rates is increasing.

Ironically, this shift toward more interest dependence was a byproduct of a shift towards capital intensive businesses to diversify away from the agency commission business, itself cyclical. Therefore, I want to emphasize that whatever long range plans we, as securities firms management, must develop to build our businesses' profitability, we must do so in the knowledge that there are broad events beyond our control, something not easy for a CEO to acknowledge, and for which we must develop an alternate business plan. Under any scenario, it is absolutely required that there be tight control and allocation of costs relating to profitability.

So much for the past. Under what circumstances can the securities industry continue to grow and, as it must, prosper? Unless the industry is prosperous, it will be incapable of raising the capital needed, domestically and internationally, for corporations, governments and for the needs of our fellow citizens. It will also be hard pressed to advise clients, individual and institutional, on their investment needs for the present and for tomorrow.

Individuals Still Investors

The securities industry, in the past three years, has faced the challenge of attempting to be profitable by massive restructuring, by cost cutting, by changing priorities to meet client needs, by regularizing compensation in many instances. It has, at the same time, continued to train its personnel and supervise their activities without reducing, in any meaningful way, the resources devoted to customer protection and supervision of its employees.

There is clear evidence that investors have not abandoned investing. Our clients are more sophisticated and better educated and more demanding. And we can take some credit for that because of our research and client education programs. And the media can take some credit for it because of their expanded economic coverage.

Individual investors have not abandoned the management of their financial assets. They are interest rate and risk sensitive and this is reflected in their affinity for money market funds and by their shift to conservative investing practices when appropriate. CDs, money market and other mutual funds as well as a variety of fixed income investments have grown in popularity as interest rates declined. And in the first quarter of 1991, there is ample evidence of renewed interest in equities. This mixing of investment priorities reflects the changing needs of the increasingly sophisticated investor. This trend will greatly expand in the coming years.

Educated investors see value in long term investing, in prudent allocation of their financial assets and they are sought after by brokers who are well trained and equipped with the financial vehicles to serve these investors. Brokers are as eager as clients to build relationships, to plan for the future on a longer term basis and to meet the specialized requirements of their clients.

Despite the trend toward mutual funds and managed accounts for a fee, trends which will continue, there is a not yet fully recognized, equally important growth in investing in specific securities by individuals who retain the power of decision over their own investments.

Government Policies Have to be Examined

There is one area of concern, however, and it involves government economics and tax policies, but above all, government's way of looking at things. Within the past few years, while tax rates on ordinary income have surely gone down, investment incentives have withered away. Capital gain tax incentives no longer exist. The use of IRAs was severely curtailed in 1986. The U.S. remains the only one of eleven industrial countries to do nothing about alleviating the tax burden on dividend income. And the tax bias in favor of debt and against equity is so unrelenting that equities have fallen from 55% of securities outstanding in 1970 to 35% in 1990.

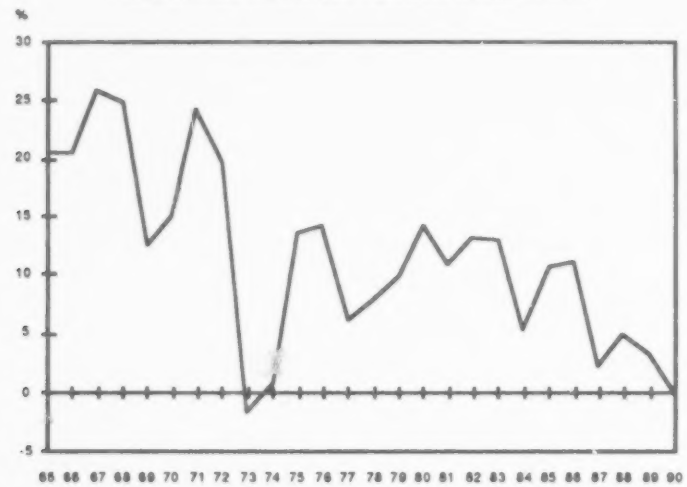
Our elected representatives must reverse the process and overcome their fear of profit and incentive for profit. The U.S., unquestionably the standard of the world for economic freedom, must return to its economic heritage and embrace incentives with enthusiasm and with faith in the future. If a meaningful sea change is perceived on this subject, then the future of the securities industry will be very bright indeed.

Edward I. O'Brien
President
Securities Industry Association

RECENT INDUSTRY AND MARKET TRENDS

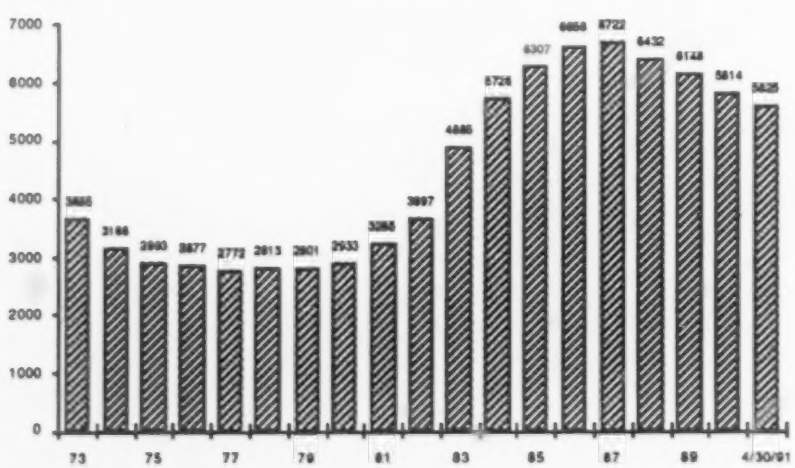
Although the profitability picture in our industry has changed dramatically for the better this year, the industry's three-year plus recession and last year's record loss are still fresh in our minds. Indeed, widely used trends measuring industry profitability have been in a downward slide for many years as shown below.

SECURITIES INDUSTRY PRE-TAX PROFIT MARGIN

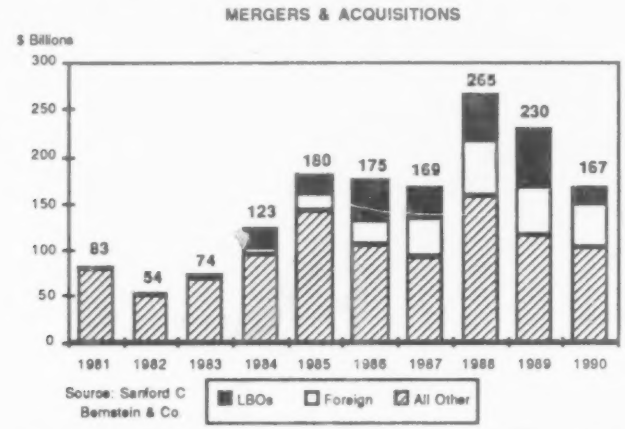


The industry incurred a record loss last year; weathered a string of four quarterly losses out of the five reporting quarters ended last year; survived shrinking equity and total capital bases; endured declining commissions to late 1982/early 1984 levels, and mounted a 20% contraction in its workforce to downsize the cost base. Indeed, since year-end 1987, 1,100 NASD member firms, or 16% of the industry, have disappeared in mergers or closings bringing us under 1984's total.

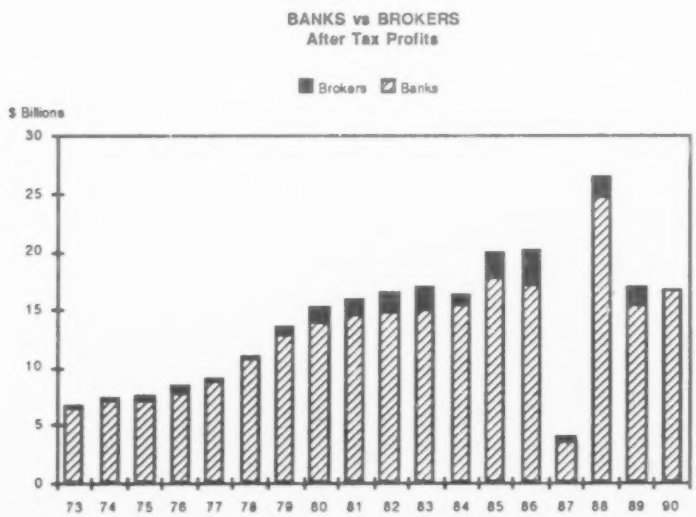
NASD MEMBER FIRMS



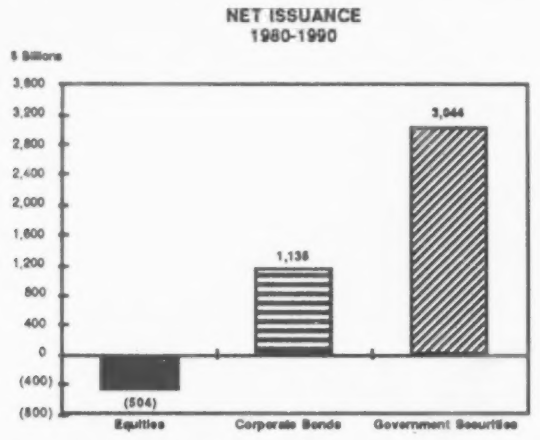
In the 1980s, American finance and U.S. capital markets were accused of being a gambling casino epitomized by greed where the way to win was by stacking the deck. Takeovers, junk bonds, bundling and unbundling of assets, etc., have come and gone, leaving behind successes and failures. The highly profitable M&A area is a prime example, which continues to dwindle from its heyday as seen below. More importantly, it seems that these developments have pitted Wall Street against Main Street, British industry against the City of London.



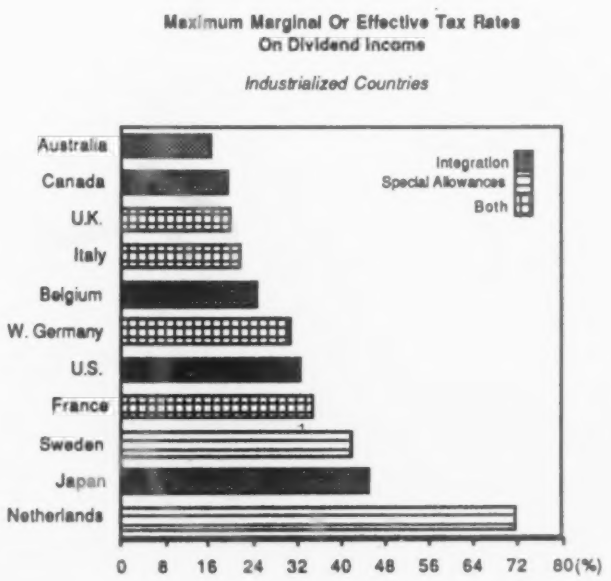
Many individuals feel finance should be the slave of industry, but became its master in recent years. Perhaps because of this, the market deviated from good sense and sound financial principles. Despite significant liberalization and freedom in our capital markets, many financial intermediaries are still under severe profit pressures. Commercial banks are weaker than at any time during the last 50 years. Indeed, Congress and the Administration are intent on debating the possible intermingling of commerce and banking as a means of alleviating U.S. banking's profitability problems. As shown below, the securities business is not the answer to the oversupply of banks in this country and their profitability problems.



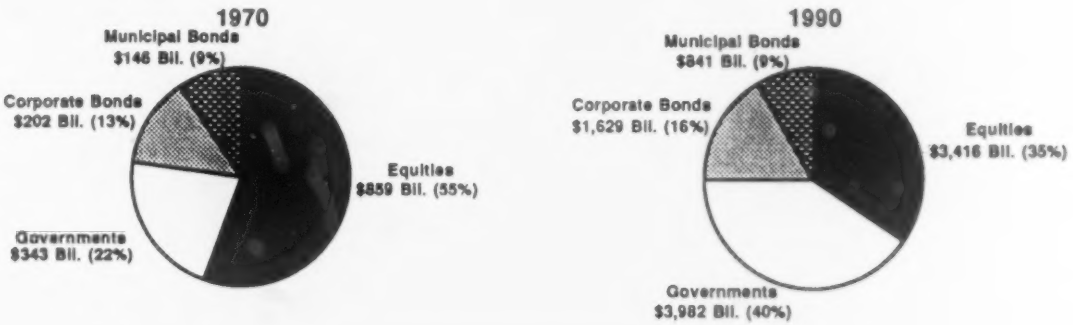
In the 1980s, there were times when M&A activity induced arbitrary stock market valuations while management came under fire for too much devotion to asset shuffling and too little to investing in the future. On its face, the resultant corporate leveraging, from equity into debt, sounds like a deliberate move from health to sickness.



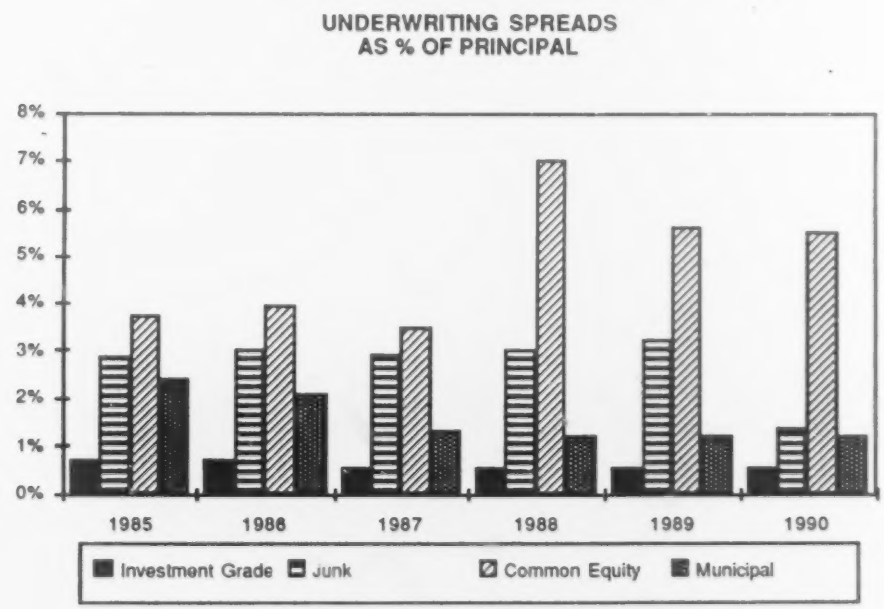
In the 1980s, buyers thought they could raise cash flows by breaking up companies, giving managers different incentives and controls, and by fully exploiting tax breaks favoring debt over equity. Naturally, this concept can get taken too far. Due to the double taxation of corporate income (dividends), the value of a firm may actually rise by taking on debt. Although there was a lowering of tax rates in 1986, the simultaneous removal of tax credits for investment and limiting depreciation write downs sustained this strong incentive to borrow. The U.S. remains the only one of eleven industrialized countries to do nothing about alleviating the tax burden on dividend income.



The movement away from equity to debt hurts the profitability of the securities industry. Sales spreads, in general, are higher for equities than for debt. Also, the instruments with the lowest underwriting spreads grew the fastest during the 1980s. In particular, government and corporate bonds have grown in relative importance to equities. Governments now comprise 40% of domestic securities outstanding compared to 22% in 1970. Meanwhile, equities have fallen from 55% of securities outstanding in 1970 to 35% in 1990.



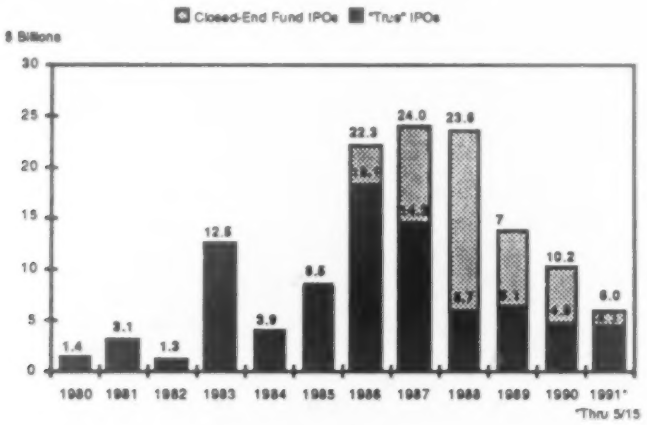
Adding insult to injury, spreads on all types of securities have trended down since the mid-1980s. Although spreads vary substantially even within the same class of securities, the general thrust has been downward, as seen below.



More damaging, the IPO market has been dormant until recently. Unless we can raise capital for new companies, job growth and international competitiveness will be stifled. Fortunately, in recent months a rash of IPOs have come to market

successfully with more in the pipeline. Although this is encouraging, it should not be overdone lest we chase investors from this risky, but vital market for years to come.

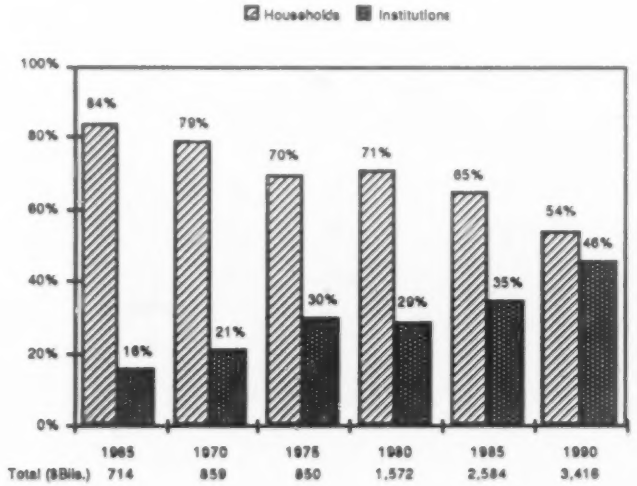
"TRUE" IPOs HAVE CRASHED SINCE THE CRASH



Holders of Equities

In 1950, Charles Wilson, President of General Motors, set up a pension fund for GM employees that was not limited to investing in GM securities. Within a year, 8,000 new plans were written. Our equity markets have not been the same since. In 1965, individual investors held 84% of companies' shares outstanding; by 1990, this percentage had plunged to 54%. Nevertheless, individual investors held $1.8 trillion of equity at year-end 1990 compared to only $600 billion in 1965. This $1.8 trillion excludes their stake in pension funds and mutual funds as well. However, institutions do dominate the trading of equities. This fact makes the markets move faster than ever before and seem more unforgiving of every corporate mistake.

HOLDINGS OF U.S. EQUITIES



Conclusion

The U.S. financial system has more freedom than ever before. That makes it an efficient and ruthless broadcaster of economic, political, and social frailties. The financial markets reflect rather than cause change. They reflect changes in taxation, cost of funds, changing bankruptcy rules, etc. The hostile takeover is the most prominent financial development because it exposes capitalism in the raw: high profits can be made or lost by risking huge sums of money for short periods of time while many individuals wait silently for an outcome affecting their jobs and lives. Surprisingly, the recent wave of mergers may have been more successful than those of the late 1960s and early 1970s. Although fewer of those mergers were hostile, there were more disasters because of the nonexistence of synergies across very different businesses.

Shareholders and managers have been different individuals since the 1930s. Back then, owners were rich individual investors with a direct stake in the outcome of the business they invested in; today they are pension funds or other financial intermediaries acting on behalf of many individuals. Such owners are investors in a vast portfolio of securities. Today they benefit from the market's general performance rather than from a particular company's. Recently, there are signs that the market is seeking to bridge the gap between ownership and control. However, this problem will likely remain given the dominance of institutions.

This is but one of many good reasons for targeting savings incentives for individuals, such as the IRA proposals by Senators Bentsen and Roth. A capital gains differential would not be a crazy idea either, or at least investors should be allowed to adjust their cost basis for inflation.

Finally, isn't it time America did something positive about the double taxation of corporate income without worrying about the revenue loss to the government? The markets simply reflect ill-advised government and corporate policies. Government and industry won't recover full health until we follow responsible fiscal policies at all government levels and lighten the real tax burden on profits and risk taking.

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